

**COORDINATED ISSUE  
CONSTRUCTION/REAL ESTATE INDUSTRY  
ADVANCE PAYMENTS FROM CONSTRUCTION SERVICES CONTRACTS**

**ISSUE:**

Whether an accrual basis taxpayer must report advance payments received from construction services contracts in gross income in the year of receipt.

**FACTS:**

In the construction industry, there are two basic categories of contracts: construction contracts and construction services contracts (design, engineering and construction management). For financial purposes, revenue from both contracts is accounted for under a percentage-of-completion method, or in very limited circumstances under the completed-contract method.

For tax purposes, however, a taxpayer generally must use the accrual method of accounting under section 446 for reporting gross income from construction services contracts. On the other hand, a construction contractor that enters into a construction contract that will not be completed before the end of the taxable year in which it is entered, and whose average annual gross receipts for the 3 taxable years preceding the year in which such contract is entered into exceed \$10 million, generally must report gross income from the contract under the percentage-of-completion method of section 460.<sup>1</sup>

In this case, an accrual basis taxpayer (for federal income tax purposes) is engaged in construction services contracts. These contracts are cost plus either a percentage or a fixed fee. The terms of these contracts generally entitle the taxpayer to be compensated for:

- (1) certain defined costs incurred in performing the agreed services (primarily labor and salaries), and
- (2) a fee for those services, based on either a percentage of the costs or a set amount.

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<sup>1</sup>For an analysis of the distinctions between construction contracts and construction services contracts, please refer to the Construction Management Coordinated Issue Paper.

All of the construction services contracts require the client to advance funds to the taxpayer based on the amount of costs the taxpayer estimates it will incur in the next subsequent period, usually, the next month. The contracts also provide that advanced funds must be applied to the taxpayer's costs incurred on the contract, and that any excess determined at the time the contract is either completed or terminated must be returned to the client. Similarly, excess fee payments, if any, must be returned to the client.

With respect to the cost plus a percentage fee contracts, the taxpayer determines the gross income for financial and federal income tax purposes at the end of each year by taking into account an amount equal to the costs incurred during the year plus the stated percentage of the costs. In the case of the fixed fee contracts, the taxpayer determines gross income for financial and tax purposes at the end of each year by taking into account an amount equal to the costs and the appropriate portion of the fixed fee. The amount of gross income from the fixed fee is the portion of the total fee equal to the ratio of all the man-hours worked by year-end to the total estimated man-hours, or the costs incurred to date to total estimated costs, less amounts included in previous years, for each contract.

## **DISCUSSION:**

Both of these percentage-of-completion methods are permissible under generally accepted accounting principles for determining gross income from a construction services contract for financial accounting purposes. However, they are not permissible methods for federal income tax purposes.

Federal income tax principles generally require accrual basis taxpayers to report gross income in the taxable year when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See Rev. Ruls. 79-292, 1979-2 C.B. 287, and 84-31, 1984-1 C.B. 27. Thus, this principle requires an accrual basis taxpayer to include advance payments received from construction services contracts in gross income in the taxable year in which they are actually or constructively received, rather than when earned at a later time under general accrual accounting principles. See Treas. Reg. §§ 1.451-1(a), and 1.451-2(a).

Advance payments have traditionally been considered gross income in the year of receipt. Rev. Rul. 60-85, 1960-1 C.B. 181 states:

The Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, . . . regardless of whether the period of proration is definite or indefinite, unless a different treatment is

specifically provided in the Internal Revenue Code . . . or the regulations thereunder.

Moreover, the Supreme Court, pursuant to section 446(b), has consistently held that the failure to report advance payments in the year of receipt does not clearly reflect income, and that they should be included in income in the year received. Schlude v. Commissioner, 372 U.S. 128, 137 (1963) (the "right to receive" income determines the time for its inclusion in income); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Auto. Club of Mich. v. Commissioner, 353 U.S. 180 (1957). In each of these cases, the taxpayers received prepaid income for services to be performed in the future that they did not include in gross income in the year of receipt. The Supreme Court held that the taxpayers' method of accounting did not clearly reflect income because deferring the advance payments would not match revenue and expenses more clearly than including the payments in gross income when received.

The method of accounting used by the taxpayer discussed in this paper for construction service contracts fails to clearly reflect income to the extent the taxpayer has not included its advance payments received from construction services contracts in gross income in the taxable year of receipt. See also, RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), cert. denied, 457 U.S. 1133 (1982), Simplified Tax Records, Inc. v. Commissioner, 41 T.C. 75 (1963), and Popular Library, Inc. v. Commissioner, 39 T.C. 1092 (1963) (advance payments for services to be performed in future years and received without restriction as to use are income in the year received).

It should be noted, however, that the Service recognizes a limited exception that allows an accrual basis taxpayer to defer including some advance payments for services in gross income for one taxable year under Rev. Proc. 71-21, 1971-2 C.B. 549. A taxpayer may request a deferral of an advance payment for services from gross income under Rev. Proc. 71-21 if the contract provides that all services must be performed by the end of the taxable year immediately following the end of the taxable year in which the advance payment is received. In addition, the amount of the deferral from or inclusion in gross income for tax purposes must conform to the amount of income the taxpayer defers or includes for book purposes. Rev. Proc. 71-21 is not available for any contract where any portion of the services may be performed after the end of the taxable year immediately following the year the advance payment is received; where any part of the services are to be performed at an unspecified time, possibly after the end of the taxable year immediately following the year the advance payment is received; guaranty or warranty contracts; and contracts for prepaid rent or interest.

Taxpayers may also advance other theories to support the deferral of advance payments from construction services contracts from gross income. See, e.g., Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968). In these cases, the courts allowed the deferral of advance payments for services under a theory that the

performance of services in the future was fixed and definite. However, the Service does not agree with these cases. See Boise Cascade Corp., AOD CC-1986-014 (Feb. 19, 1986); Artnell Co., AOD-OM 17,542 (July 27, 1971); see also Hagen Advertising Displays, Inc. v. Commissioner, 47 T.C. 139 (1966), aff'd, 407 F.2d 1105 (6th Cir. 1969). In addition, taxpayers may not defer including advance payments from construction service contracts in income under Commissioner v. Indianapolis Power & Light Co., 439 U.S. 203 (1990), because the advance payments are not deposits.

### **CONCLUSION:**

Taxpayers must include advance payments from construction services contracts in gross income in the year of receipt except to the extent Rev. Proc. 71-21 allows a deferral.